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Stop Payment Orders Under the Uniform Commercial Code

STOP PAYMENT ORDERS UNDER THE UNIFORM COMMERCIAL CODE

The adoption by Indiana of the Uniform Commercial Code will present numerous and varied problems for the practicing lawyer, among which will be bank deposits and collections. When the initial draft of the Code was published in 1948, bank collections and deposits were treated in conjunction with commercial paper in article 3,[1] but since bank collections and deposits presented their own particular problems and certain non-negotiable items important to bank collections and deposits were not within the scope of article 3, later drafts of the Code provided separate treatment in article 4.[2] Although other articles of the Code have received favorable comment, article 4, dealing with bank collections and deposits has produced heated controversy.[3] In earlier drafts contractual modification of the provisions of article 4 was not allowed, and since a certain amount of flexibility is essential to bank procedure in order to meet changing circumstances, the banks and lawyers engaged in the banking business opposed it.[4] As one writer commented, the inflexibility of the Code in article 4 was too protective of the general public.[5] All the criticism, however, was not that article 4 was anti-bank, since it was also contended that article 4 was basically an unfair piece of class legislation favoring banks, as opposed to depositors, because it approved surreptitious fine print waivers appearing on the bank form, in spite of the fact that many courts had on the grounds of policy refused to enforce contracts of that kind.[6] To meet the inflexibility criticism, article 4 was liberalized by the commissioners, but even in its new form it was unacceptable to a study committee established by the New York legislature,

1. Brome, *Bank Deposits and Collections,* 16 LAW & CONTEMP. PROB. 308 (1951).
2. CLARKE, BAILEY & YOUNG, BANK DEPOSITS AND COLLECTIONS 12 (1959).
3. Before the present edition of the Uniform Commercial Code was adopted a study committee established by the New York Legislature recommended that the legislature not adopt the Uniform Commercial Code in its then present form, mainly because of the severe criticism of articles 3 and 4 dealing with commercial paper and bank collections and deposits respectively. CLARKE, BAILEY & YOUNG, *op. cit. supra* note 2, at 13; see Brome, *supra* note 1, at 308.
4. CLARKE, BAILEY & YOUNG, *op. cit. supra* note 2, at 12.
5. See Brome, *supra* note 1; Mr. Brome's principal objection seemed to lie in the belief that the banks should have more flexibility in dealing with their depositors.
6. See Beutel, *The Proposed Uniform (?) Commercial Code Should Not Be Adopted,* 61 YALE L.J. 334 (1952). Professor Beutel conveys the impression that article 4 of the Uniform Commercial Code was designed primarily to protect the bank in all their transactions and was pushed through by the bank lobbies.

since it was still considered too restrictive on banks.[7] This unacceptability caused further liberalization and refinement of article 4 and the present draft represents, in the main, the results of the hearings and revisions of the New York study committee.

Although stop payment orders are but one segment of the liberalized article 4, they involve the debtor-creditor relationship of banks and depositors as well as the collection process and illustrate the problems of imposing new law on old that might arise under any part of the Code.

I.

Basic to an understanding of the stop payment order under the Code is the knowledge of prior legal developments of the stop payment order under the common law and the Uniform Negotiable Instruments Law. At common law a check was an order on a bank to pay a sum certain to the holder of the check and the drawer had an absolute right to order the bank to withhold payment on the check prior to payment.[8] The origin of this absolute right to stop payment is uncertain, since several rationalizations of the right are to be found. One theory was that the check was an offer by the depositor to borrow money and until the bank accepted the offer by paying the check the depositor could revoke his offer.[9] Another theory was that the drawee bank was in the best position to know and control a depositor's account and if the drawer ordered a stop payment the drawee bank should honor the request.[10] The third theory was based on a supposed contractual relationship arising out of the depositor-bank relationship in which the bank was bound to comply with the stop payment order.[11] Moreover, at common law, if the bank paid over the stop payment order the bank could not charge the drawer's account or recover the amount paid.[12]

Undoubtedly, because of the feeling that it would be harsh to hold a bank entirely responsible for payment of a check over the stop payment order, some jurisdictions, mitigating the absolute stop payment right

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7. CLARKE, BAILEY & YOUNG, *op. cit. supra* note 2, at 14.

8. See Dunlap v. Commercial Nat'l Bank, 50 Cal. App. 476, 195 Pac. 688 (1920); Ballard v. Home Nat'l Bank, 91 Kan. 91, 136 Pac. 935 (1913).

9. See SPAHER, THE CLEARING AND COLLECTION OF CHECKS 3 (1926); Moore, Sussman & Brand, *Legal and Institutional Methods Applied to Orders to Stop Payment of Checks*, 42 YALE L.J. 817 (1932).

10. See Price v. Neal, 3 Burr. 1355, 97 Eng. Rep. 871 (K.B. 1762).

11. See Viets v. Union Nat'l Bank, 101 N.Y. 563, 5 N.E. 457 (1886).

12. See Hiroshima v. Bank of Italy, 78 Cal. App. 362, 248 Pac. 947 (1926); Tremont Trust Co. v. Burack, 235 Mass. 398, 126 N.E. 782 (1920); Sutter v. Security Trust Co., 95 N.J. Eq. 44, 122 Atl. 381 (1923). However there were a few cases that did allow the bank to charge the drawer's account. See Arkansas Nat'l Bank v. Gunther, 127 Ark. 149, 191 S.W. 901 (1917); Usher v. A. S. Tucker Co., 217 Mass. 441, 105 N.E. 360 (1914).

where the check had passed into the hands of a bona fide holder,[13] held that the check created an equitable assignment of the drawer's deposit to the bank and the drawer was precluded from stopping payment on the check.[14] The adoption of the Negotiable Instruments Law, however, reversed the trend toward equitable assignment and reinstated the common law rule that the drawer could order stop payment of the check at any time prior to payment.[15]

As would be expected banks then devised a technique to protect themselves in case a check was paid over a stop payment order. The banks entered into release agreements with their depositors to limit their liability in case a check was paid over a stop payment order through inadvertence, mistake or accident.[16] Release agreements were entered into at the time the stop payment order was given, but some courts that undertook the release question on straight contract principles held that such an agreement was void for lack of consideration.[17] Even when the re-

13. If the check was in the hands of a bona fide holder and the bank refused to pay the check, the holder of the check could bring an action against the bank for refusing to pay. See Loans & Sav. Bank v. Farmers & Merchant's Bank, 74 S.C. 210, 54 S.E. 364 (1906).

14. This thought probably arose because some courts believed the drawer should be held responsible since he was the one that put the check in circulation. See Union Nat'l Bank v. Oceana County Bank, 80 Ill. 212, 22 Am. Rep. 185 (1875); Loans & Sav. Bank v. Farmer & Merchant's Bank, *supra* note 13; Pease v. Landauer, 63 Wis. 20, 22 N.W. 847 (1885); Moore, Sussman & Brand, *supra* note 9, at 823.

15. "A check of itself does not operate as an assignment of any part of the funds to the credit of the drawer with the bank, and the bank is not liable to the holder, unless and until it accepts or certifies the check." UNIFORM NEGOTIABLE INSTRUMENTS LAW § 189.

16.

Please endeavor to stop payment on my-our check
Drawn By .....No. .... $....
Favor Of ..... Dated ..... 19....
Reason .....

In asking this courtesy the undersigned agrees to hold the above named bank harmless for said amount and for all expenses and costs incurred by it on account of refusing payment of said check, and further agrees not to hold the said bank liable on account of payment contrary to this request if made through inadvertence, accident, or mistake.

If a duplicate check is issued or if the original check is returned, the undersigned agrees to NOTIFY THE BANK PROMPTLY. If this request is not previously revoked, the undersigned agrees that it will AUTOMATICALLY EXPIRE AT THE END OF —— DAYS FROM date hereof unless a renewal order is presented personally or by mail or telegraph. It is agreed that a service charge of ——c will be made for this order or its renewal.

To.....

....
Authorized Signature

This is a stop payment order with a release used by a bank in Indiana and it is believed to be in general use throughout the state.

17. See Commercial Bank v. Hall, 266 Ala. 57, 94 So.2d 198 (1957); Calamita v. Tradesmen's Nat'l Bank, 137 Conn. 326, 64 A.2d 49 (1949). Some courts, however, did hold a release entered into at the time of the stop payment order valid. See Annot., 1

leases were entered into at the time the depositor opened his account, thereby satisfying consideration requirements, some courts took the position that a bank could not contract away its legal responsibilities and held that the release was void as being repugnant to public policy.[18]

II.

Section 4-403(1) of the Code in providing for stop payment orders adopts a position giving the drawer an absolute right to stop payment on his check.[19] Therefore, it is, as under the Negotiable Instruments Law, important to consider the possibilities of release agreements to limit bank liability for paying over a stop payment order. Although the present edition of the Code does not have a specific section allowing banks to limit their stop payment obligations through contract or agreement as was done in some previous editions of the Code,[20] it is evident that the drafters recognized the fact that a bank might, to a limited extent, obtain release from certain duties imposed on it by law. Section 4-103(1) provides that any provisions of article 4 may be altered by agreement, but that, "no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care."[21]

Since the typical release agreement provides that the drawer will not hold the bank liable if the check is paid over the stop payment order

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A.L.R.2d 1054 (1947). For an Indiana case holding such a release valid see Hodnick v. Fidelity Trust Co., 96 Ind. App. 342, 183 N.E. 488 (1936).

18. See Speroff v. First Cent. Trust Co., 149 Ohio St., 415, 79 N.E.2d 119 (1948); Thomas v. First Nat'l Bank, 376 Pa. 181, 101 A.2d 910 (1954).

19. UNIFORM COMMERCIAL CODE § 4-403 reads:

(1) A customer may by order to his bank stop payment of any item payable for his account but the order must be received at such time and in such manner as to afford the bank a reasonable opportunity to act on it prior to any action by the bank with respect to the item described in Section 4-303.

(2) An oral order is binding upon the bank only for fourteen calendar days unless confirmed in writing within that period. A written order is effective for only six months unless renewed in writing.

(3) The burden of establishing the fact and amount of loss resulting from the payment of an item contrary to a binding stop payment order is on the customer.

20. The following drafts of the Code specifically purported to allow banks to contract to absolve themselves from liability for paying over a stop payment order. UNIFORM COMMERCIAL CODE § 3-415(4) (May, 1949 Draft); UNIFORM COMMERCIAL CODE § 4-202(3) (Spring, 1950 Draft); UNIFORM COMMERCIAL CODE § 4-503 (Sept., 1950 Draft); UNIFORM COMMERCIAL CODE § 4-103(1) (Spring, 1951 Draft).

21. UNIFORM COMMERCIAL CODE § 4-103(1). In full the section provides that: The effect of the provisions of this Article may be varied by agreement except that no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care, or can limit the measure of damages for such lack or failure; but the parties may by agreement determine the standards by which such responsibility is to be measured if such standards are not manifestly unreasonable.

through inadvertence, mistake or accident,[22] there would seem to be some doubt that a valid stop payment order release can be drafted under section 4-103(1) of the Code. Previous to the Code, the courts had interpreted these three words of the typical release to include negligence or lack of ordinary care.[23] Thus, if the same release agreements are used under the Code, these words will have to take on a new meaning, but even then, it is difficult to see how inadvertence, mistake or accident could occur if ordinary care were taken. For purposes of discussion, however, it will be assumed that a valid stop payment release may be drafted under section 4-103(1) of the Code.

Prior to the Code, releases were entered into either at the opening of the account[24] or at the time the stop payment order was issued by the drawer.[25] The adoption of the Code, however, will change these alternatives to the extent that the banks out of necessity will have to enter the release agreements at the opening of the account instead of at the time of the stop payment order. This is a result of the language of section 4-403(1) which gives the drawer an absolute right to stop payment; thereby implying that he does not have to sign a release to have the bank stop payment.

While a release entered into at the time of the opening of the account would not fail for lack of consideration, because it is part of the original account agreement,[26] there is still the question of whether the bank should give the drawer adequate notice of the prior release agreement when the depositor places his stop payment order with the bank. As an example, consider the problem of a release entered into by a bank and drawer five years prior to a stop payment order. In all probability, the depositor has forgotten about the release agreement and believes that the bank will be absolutely liable if the bank pays over a stop payment order. The drawer will be in for quite a shock if the bank does pay over his stop payment order and is protected by the release agreement. Since the Code does not provide that the bank must give notice of limited liability, a situation is present in which the bank might well take advantage

22. See note 16 *supra.*

23. See, *e.g.*, Tremont Trust Co. v. Burack, 235 Mass. 398, 126 N.E. 782 (1920).

24. In Mahon Co. v. Huntington Nat'l Bank, 62 Ohio App. 261, 23 N.E.2d 638 (1939) the agreement was contained in the rules of the bank; while in Elder v. Franklin Nat'l Bank, 25 Misc. 716, 55 N.Y.S. 576 (1899) the agreement was encompassed in the passbook.

25. Tremont Trust Co. v. Burack, 235 Mass. 398, 126 N.E. 782 (1920); Gaita v. Windsor Bank, 251 N.Y. 152, 167 N.E. 203 (1929); Speroff v. First Cent. Trust Co., 149 Ohio St. 415, 79 N.E.2d 119 (1948) are cases involving releases entered into at the time of the stop payment order.

26. See notes 17 and 18, and accompanying text *supra.*

of its position and not inform the drawer of the prior release agreement.

There seem to be valid reasons, however, for requiring the bank to give notice. It might be contended that, since the bank requires specific notice of the stop payment order, the bank should give specific notice of the release agreement in order to provide the drawer with all the relevant facts necessary to make a competent decision on whether or not to issue the stop payment order. Also, it is arguable that good sense and decency require the bank to give notice, because as shown in the example, the average drawer who has had limited contact with the stop payment procedure probably does not know about the agreement and may well believe the bank is subject to absolute liability if it does pay over the stop payment order. In the face of such reasons for requiring bank notification of their stop payment order limited liability, the position which would allow the banks to take advantage of the fact that the Code does not provide for such a notification should fall. It would seem a judicial or legislative evolution of a notice requirement would not only have a legitimate ground for existence, but would supplement the liability limiting provision of section 4-103(1), a *general* Code section that may not contemplate all the problems peculiar to the stop payment release.[27]

Since banks can enter into release agreements to protect themselves, if they follow a standard of "ordinary care,"[28] the ascertainment of that standard is relevant. The Code in an attempt to furnish the banks and courts with a standard have attempted to define ordinary care. Section 4-103(3) of the Code provides that:

> Action or non-action approved by this Article or pursuant to Federal Reserve regulations or operating letters constitutes the exercise of ordinary care and, in the absence of special instructions, action or non-action consistent with clearing house rules and the like or with a general banking usage not disapproved by this Article, prima facie constitutes the exercise of ordinary care.[29]

Unfortunately, the Code's attempt to define ordinary care will probably meet with little success in stop payment procedure. There is a wide variance in the handling of stop payment orders from community to

27. It might be argued in support of a notice provision that, since UNIFORM COMMERCIAL CODE § 4-103(1) is a general liability alteration section, rather than a section expressly dealing with stop payment order releases, it only sets a minimum standard of alteration; therefore, allowing states to set more rigid standards in the areas where specific liability limitation problems exist.

28. See UNIFORM COMMERCIAL CODE § 4-103(1); full text at note 21 *supra*.

29. UNIFORM COMMERCIAL CODE § 4-103(3).

community as well as from bank to bank in the same community.[30] In addition, some banks even use a different procedure in handling individual stop payment orders depending on whether the depositor is a regular customer or not.[31] Unless the Code provides some incentive for banking institutions to establish a single standard for the handling of stop payment orders, the courts will have to determine in each individual case whether the bank exercised ordinary care. Even if the local clearing houses or the Federal Reserve, for example, were to establish a single standard of procedure for stop payment orders, there is the danger that the standard chosen would give a minimum amount of protection to the depositors.[32]

Assuming, then, that there would not be a single standard for the banking industry in the handling of stop payment orders, some consideration must be given to section 4-103(1) of the Code, granting banks the opportunity to set up the standards of ordinary care as long as they are not "manifestly unreasonable."[33] While there is a possibility of strong adhesion tactics to obtain the depositor's agreement to bank devised standards, one writer suggests that the banks may not use their position to do this, because the banks must satisfy their depositors in order to retain the depositor's business.[34] This position, however, only views the bank as a single entity. If a low standard is set by all the banks of a given community, they are in an adhesion contract position and can dictate policy to the depositor in need of a checking account. The only apparent solution to the problem would seem to be to determine, after the adoption of the Code, if any abuses develop and to counteract them with a supplemental state law establishing minimum standards of ordinary care for stop payment procedure.

Possibly the only aspect of ordinary care that has been solved in Indiana, which is relevant in stop payment procedure, is the problem of notification. If a check is brought to a teller and paid in cash, there will be less time to notify bank personnel and prevent the check from being paid, than if the check is brought in to be deposited in the holder's account. Thus, notification is an important part in deciding whether a bank exercised ordinary care. The question of when a check is paid, and thus too late for a stop payment order to be effective, is discussed in an-

30. See 28 IND. L.J. 95, 101 (1952).
31. Remarks of Mr. R. N. Fitzpatrick, Executive Vice-president, Old-First National Bank, Bluffton, Indiana.
32. This seems to be the essence of the argument of Beutel. Beutel, *supra* note 6.
33. See UNIFORM COMMERCIAL CODE § 4-103(1).
34. 28 IND. L.J. 95 (1952).

other part of this symposium,[35] but mention should be made here of section 1-201(27) of the Code. Subsection (27) defines what is notice, knowledge, or a notice or notification to an organization exercising due diligence. In the prior editions of the Code, due diligence was not defined for this area; but the Indiana legislature adopted an amendment to subsection (27)[36] which defines due diligence and the requirement of an individual in an organization in communicating information to someone else in the notification chain. It would seem, then, that a bank meeting the requirement of subsection (27) would be exercising ordinary care in the notification chain if it were to follow the procedure provided in subsection (27).

In addition to problems in determining what is ordinary care in the stop payment order procedure under the Code, there are problems, for which the Code offers no solution, as to whether the drawer or the drawee should have the burden of proof of ordinary care. If there is no release agreement, the bank would be absolutely liable and the drawer would only have to establish the amount of damages.[37] Where there is a release, however, the bank is not liable unless there was a failure to exercise ordinary care on the part of the bank and, therefore, the burden of proof is relevant. The determination of this question will be very important to the drawer because he is generally in an unenviable position of not having sufficient information to prove whether the bank did or did not exercise ordinary care.

One method that has been suggested to help alleviate the unenviable position of the drawer is similar to the doctrine of res ipsa loquitor[38] and would force the bank to come forward with the evidence and prove that it did exercise ordinary care. Such a doctrine would not only seem apt in its analogy, but it certainly would serve to legitimately equalize the

35. See generally the accompanying note, *Bank Collections under the Uniform Commercial Code.*

36. See UNIFORM COMMERCIAL CODE § 1-201(27). The amendment to UNIFORM COMMERCIAL CODE § 1-201(27) which the Indiana legislature adopted reads:

> An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

37. See UNIFORM COMMERCIAL CODE § 4-403.

38. See Beutel, *The Proposed Uniform Bank Collection Act and Possibility of Recodification of the Law on Negotiable Instruments,* 9 TULANE L. REV. 378, 404 (1934-35). Also the writer in 28 IND. L.J. 95, at 105 (1952) makes the suggestion that res ipsa loquitor might be used to force the bank to come forward and show that it acted with ordinary care.

positions of the stop payment order litigants.[39] Under the suggested doctrine, once the drawer has shown that the bank did pay over the stop payment order and established the amount of his damages the bank would then be forced to come forward and prove that it did exercise ordinary care.[40]

Based on the fact that under the Code the general stop payment rule appears to be absolute liability under section 4-403(1), the exception to such a rule would seem to be a release. Therefore, another argument for placing the burden of proving the exercise of ordinary care on the defending bank would be to draw an analogy to the contract doctrine of impossibility. When the plaintiff in a contract action shows a breach, among the various defenses that may be set up by the defendant, it may be argued supervening events have made the performance impossible or that the performance of the agreed equivalent has become impossible and the burden of proving the exception of impossibility falls on the defendant.[41] If courts would use the same kind of reasoning for stop payment orders, the bank with a release, which is an exception to Code stop payment liability, would be required to raise it as a defense and prove that they did exercise ordinary care in handling the drawer's stop payment order.

The burden of proving ordinary care should be on the party who has the facts, certainly in the case of stop payment orders, the bank. The

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39. In the stop payment situation the bank has exclusive control of the stop payment procedure; an exercise of ordinary care in all probability would stop the payment of the check and the drawer is a passive factor once the order has been issued. For a discussion of the elements of res ipsa loquitor see PROSSER, TORTS § 42 (2d ed. 1955); WIGMORE, EVIDENCE § 2509 (3d ed. 1940).

40. Under [UNIFORM COMMERCIAL CODE] § 4-103(3) proof that the bank's efforts conformed to a general banking usage would create a prima facie, not a conclusive, presumption of ordinary care. Thus the bank would set forth the procedures it employed in attempting to catch the fugitive check, and then would endeavor to demonstrate that these procedures approximate those used by nearly all banks in its commercial area. In most jurisdictions, this would offset the suggested presumption in favor of the depositor, leaving the case to be decided upon proven specific acts of negligence, or proof that the general banking usage itself fails to measure up to the standard of care.

28 IND. L.J. 95, n.46 (1952). This is similar to the result reached by the court in Carroll v. South Carolina Nat'l Bank, 211 S.C. 406, 45 S.E.2d 729 (1947). There a bank had paid over a stop payment order and the depositor was bringing suit to recover the amount of the check. When the stop payment order was given, an agreement was entered into releasing the bank from liability if the check was paid through inadvertence or oversight. The court said that a bank had a duty to act in good faith and to exercise reasonable care after it had received a stop payment order and if it paid over this order it had the burden of showing it acted in good faith and exercised reasonable care. The court held that the mere fact of payment over the stop payment order established a prima facie case holding that it was not unreasonable to require the bank to come forward because the depositor could not be expected to explain the circumstances under which the check was paid.

41. CORBIN, CONTRACTS § 1320 (1952).

drawer cannot make a cogent argument that the bank failed to exercise ordinary care, unless he knows all the facts of the bank stop payment procedure. Therefore, it would seem to be both equitable and logical to place the burden of proving the exercise of ordinary care on the bank defending the stop payment order liability.

III.

Under section 4-403(2) of the Code an oral stop payment is valid for fourteen days unless renewed in writing, while a written stop payment order is valid for six months.[42] Although section 4-403(2) seems clear, there is a question whether the six month period starts from the date of the oral order or from the date when the oral stop payment order is confirmed in writing. For example, consider a check on which the drawer has ordered an oral stop payment and a week later he confirms the oral stop payment in writing. In this situation, the bank is faced with various alternatives in determining whether to pay the check when presented for payment six months and two days after the oral stop payment was given and less than six months after the written order was given.

The argument could be made that the confirmation in writing is only a continuation of the original order and since the bank, if bound on the day of the oral order, the time limitation should start from that date. The second sentence in section 4-403(2) of the Code, however, provides that, "A written order is effective for only six months unless renewed in writing."[43] Since the Code expressly states that a written order is valid for six months, the six month limitation should start when the confirmation is given in writing. Under the hypothetical the stop payment order should still be in effect and the bank should not pay the check.

In addition to this problem, section 4-403(2) is further complicated by the provision of section 4-404 which indicates that the six month limitation on the effectiveness of stop payment orders may be inopera-

42. For the full text of UNIFORM COMMERCIAL CODE § 4-403(2) see note 19 *supra*. Indiana had a statute prior to the adoption of the Uniform Commercial Code which set a time limitation on stop payment orders. IND. ANN. STAT. § 19-2010 (Burns 1950) reads:

> No revocation, countermand or stop payment order relating to the payment of any check or draft against an account of a depositor in any bank or trust company doing business in this state shall remain in effect for more than six (6) months after the service thereof on the bank, unless the same be renewed, which renewals shall be in writing. . . .

Since the statute only provides that renewals shall be in writing it creates the inference that the original order may be oral.

43. UNIFORM COMMERCIAL CODE § 4-403(2).

tive.[44] Under section 4-404 a bank is not obligated to pay a check after six months, but may do so if acting in good faith.[45] A question, therefore, is raised as to whether a bank can pay a check over an expired stop payment order. Nothing requires the bank to act in bad faith to be liable, apparently anything less than good faith will suffice. As an example of a bank acting in less than good faith consider a check upon which a stop payment order has been in effect for six months. Despite the lack of renewal it would seem that a bank paying the check after six months acts in a manner somewhat less than good faith. Under ordinary circumstances, *i.e.,* no stop payment order, the bank would probably be acting in good faith if it did or did not pay the check after six months. In the case of a check six months old with an expired stop payment order, however, there are two elements present which negate good faith on the part of the bank. They are, a stale check and a probable knowledge on part of the employees in the notification chain that the check has been ordered stopped for six months without retraction by the drawer, combined with a knowledge that many depositors may forget to renew a stop payment order.

In *Goldberg v. Manufacturers Trust Co.,*[46] a pre-code New York case, the court said in holding a bank liable where it had paid a stale check over an expired stop payment order:

> Had the bank made inquiry before paying the check it would have ascertained from its own records that a stop payment order had been placed against the check, even though by its provisions it was revoked and nullified after the lapse of three months. This knowledge, together with the fact that it was a stale check, placed the burden upon it to inquire of the maker before making payment. Having failed in its duty to so inquire, it is chargeable with the knowledge it would have acquired, had inquiry been made. If inquiry had been made, it would have learned that the maker did not want the check to be paid and had a legal defense for its non-payment.[47]

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44. UNIFORM COMMERCIAL CODE § 4-404 reads:
A bank is under no obligation to a customer having a checking account to pay a check, other than a certified check, which is presented more than six months after its date, but it may charge its customer's account for a payment made thereafter in good faith.

45. As an example of a bank acting in good faith, consider a normal check (no stop payment order) which is paid after six months and is, of the type illustrated in UNIFORM COMMERCIAL CODE § 4-404, comment 1 which the commentators envision would be cashable (*i.e.,* a dividend check). In such a situation good faith is probably present, since the bank has no reason to suspect that the check should not be paid.

46. 199 Misc. 167, 102 N.Y.S.2d 144 (1951).

47. *Id.* at 168, 102 N.Y.S.2d at 145.

It would seem that under the language of section 4-404 of the Code the same result might well be reached, a court holding in such a situation that something less than good faith was exercised by the bank. In the comments to section 4-403, however, it is stated that "[T]he last sentence of subsection (2), together with the second clause of [s]ection 4-404, rejects the reasoning of such cases as *Goldberg*. . . ."[48] Since the language of section 4-404 does not seem to carry the impact that the above comment does, the question must be ultimately resolved by the credence given to the comments by the judiciary. If the drafters of the Code wanted to overrule the *Goldberg* case it would seem that they could have made the test of liability bad faith, rather than something less than good faith.[49]

IV.

Under section 4-403(3) of the Code, the drawer of the check has "[T]he burden of establishing the fact and amount of loss resulting from the payment of an item contrary to a binding stop payment order."[50] Under ordinary circumstances, if the holder of the check is entitled to payment and the bank pays the check, there would be no damages to the drawer and the bank could charge the drawer's account. One writer even suggests that if a bank pays a check over a stop payment order to a bona fide holder and then later dishonors a subsequent check for lack of funds, the drawer would have no cause to complain of the wrongful dishonor and the bank would not be liable for damages caused by this subsequent dishonor.[51] Although this might be the result when there is a stop payment order release, if there is no release it would not seem that section 4-403(3) limits the recoverable damages to those *directly* attributable to the item which was paid contrary to the order. Therefore, a liberal interpretation of the section would seem to allow damages for the subsequent dishonor, since although somewhat of an *indirect* result of a stop payment order, they are damages "resulting from the payment of

48. UNIFORM COMMERCIAL CODE § 4-403, comment 7.

49. Another timing problem is presented when a bank makes a decision whether or not to pay a check after an expired oral stop payment order. As an example, consider a drawer who has issued an oral stop payment order because of defective goods, but the payee then makes the goods whole and the drawer tells the payee to send the check through again after the oral stop payment expired. UNIFORM COMMERCIAL CODE § 4-404 which allows a bank to refuse payment of a check older than six months is not applicable here and since the stop payment order has expired and is no longer in effect, the bank to be safe will have to pay the check after an expired oral stop payment order. If the bank does refuse to pay the check a second time, the payee should be able to sue the drawer for damages and the drawer should be able to sue the bank for a wrongful dishonor under UNIFORM COMMERCIAL CODE § 4-402.

50. UNIFORM COMMERCIAL CODE § 4-403(3).

51. Banking L.J. Editorial Staff, *Stopping Payment of Checks*, 79 BANKING L.J. 185 (1962).

an item contrary to a . . . stop payment order. . . ."[52]

Where there is a release, however, the amount of the damages recoverable is covered in section 4-103(5) which provides that where there has been a failure to exercise ordinary care, the maximum amount of damages recoverable is the amount of the item concerned, and can be further limited if the holder of the check has some claim against the drawer that would preclude recovery for the full amount of the check.[53] Where there has been bad faith, the limit established by ordinary care is lifted and the amount of damages recoverable includes those suffered as a proximate consequence of the act. Since a subsequent dishonor probably is a proximate consequence of the payment over the stop payment order, it will be necessary, therefore, to prove a bank's bad faith in order to obtain relief where there is a release agreement.

Section 4-402 of the Code which holds a bank liable for a wrongful dishonor[54] might also provide a remedy for the drawer where there is a subsequent dishonor as a result of a bank paying over a stop payment order. Under this section, where the wrongful dishonor is due merly to a mistake, actual damages may be recovered. Thus, while a bank can enter into a release agreement that excuses it from liability if it exercises ordinary care, assuming that ordinary care can be exercised when there is a mistake, the release would not seem to relieve the bank from liability under section 4-402 because the bank by relying on the release will almost have to admit that the subsequent dishonor was a result of the mistake of paying over the stop payment order, even though it did exercise ordinary care. The bank may argue, however, that the word "mistake" is used in two different ways: that in section 4-103(1) "mistake" can still occur when a bank does exercise ordinary care, while in section 4-402 "mistake" means the failure to exercise ordinary care. This, however, does not seem to be a convincing argument because the bank would be arguing "mistake" would have different meanings for sections within the same

52. UNIFORM COMMERCIAL CODE § 4-403(3).

53. UNIFORM COMMERCIAL CODE § 4-103(5) reads:
The measure of damages for failure to exercise ordinary care in handling an item is the amount of the item reduced by an amount which could not have been realized by the use of ordinary care, and where there is bad faith it includes other damages, if any suffered by the party as a proximate consequence.

54. UNIFORM COMMERCIAL CODE § 4-402 provides that:
A payor bank is liable to its customer for damages proximately caused by the wrongful dishonor of an item. When the dishonor occurs through *mistake* liability is limited to actual damages proved. If so proximately caused and proved damages may include damages for an arrest or prosecution of the customer or other consequential damages. Whether any consequential damages are proximately caused by the wrongful dishonor is a question of fact to be determined in each case. (Emphasis added.)

article. The drawer, it would seem, could use section 4-402 and recover the actual damages resulting from a subsequent dishonor caused by the bank paying over a stop payment order.

V.

Section 4-407 of the Code provides that the bank is subrogated to the rights of certain parties, to prevent unjust enrichment, to the extent of the bank's loss through its payment over the stop payment order.[55] While the Code lists three subrogation rights, in actual practice only one may be of any value to the bank in litigation.

Under subsection (a) of section 4-407 the payor bank is permitted a right of subrogation to the rights of a holder in due course against the drawer. There is case authority to support this right of subrogation[56] and one Indiana court has held:

> One who has drawn a note or bill payable at a bank, must have done so for some purpose, and he cannot be heard to say after his banker has paid a just debt for which he had given a note, to which the maker claims no defense, that the payment was wholly voluntary and unauthorized. In such a case the banker who has paid the note is entitled to set it off in a suit to recover a balance due the depositor on general account.[57]

While this subrogation right seems like a valuable right in litigation to the bank, in actual practice where there is a holder in due course, the bank will probably never need to take advantage of the right in court. When the drawer tells the bank he is going to sue to recover his money, the bank will assert the clearly set out subrogation right of section 4-407(a)

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55. UNIFORM COMMERCIAL CODE § 4-407 provides that:
If a payor bank has paid an item over the stop payment order of the drawer or maker or otherwise under circumstances giving a basis for objection by the drawer or maker, to prevent unjust enrichment and only to the extent necessary to prevent loss to the bank by reason of its payment of the item, the payor bank shall be subrogated to the rights
(a) of any holder in due course on the item against the drawer or maker; and
(b) of the payee or any other holder of the item against the drawer or maker either on the item or under the transaction out of which the item arose; and
(c) of the drawer or maker against the payee or any other holder of the item with respect to the transaction out of which the item arose.

56. See Bedford Bank v. Acoam, 125 Ind. 584, 25 N.E. 713 (1890); Usher v. A. S. Tucker Co., 217 Mass. 441, 105 N.E. 360 (1914); Texas State Bank & Trust Co. v. St. John, 103 S.W.2d 1104 (Tex. Civ. App., 1939); *contra* Hiroshima v. Bank of Italy, 78 Cal. App. 362, 248 Pac. 947 (1926); American Defense Soc. v. Sherman Nat'l Bank, 225 N.Y. 506, 122 N.E. 695 (1919).

57. Bedford Bank v. Acoam, *supra* note 56, at 587, 25 N.E. at 715.

as authority to set off the amount of the money paid the holder in due course and the amounts will cancel out each other; in essence dissuading the drawer from litigation unless there is a holder in due course question. Also where the drawer has a real defense against the holder in due course, subsection (a) will not help the bank because the subrogation right will not be worth anything in the drawer-drawee suit.

In the case of subsection (b) of section 4-407 the bank is subrogated to the rights of the payee or any other holder of the check against the drawer.[58] In the comments following section 4-407 the situation is presented where the rights might not be on the check, but on certain goods the drawer has purchased from the payee, such as, where the goods are partially defective.[59] In such event, while the payee is not entitled to the full purchase price, the goods are still worth a certain portion of the contract price and if the drawer retains these goods he owes a certain amount to the payee. Therefore, even though the bank would not be entitled to the full amount of the check paid over the stop payment order, the bank would be subrogated to the rights of the payee against the drawer and would be entitled to his partial claim. While this seems like a logical explanation of subsection (b), the problem is whether it will be used by the banks in actual practice in this situation. Since the drawer is required to prove his actual damages arising from the payment of his check over the stop payment order,[60] he will be able to show only that he was damaged to the extent of the contract price minus the value of the defective goods, and he will not be able to show the full value of the check as damages. This is the same result subsection (b) would arrive at, but since the drawer has to prove his damages first, the bank does not have to use subsection (b).

While subsections (a) and (b) of section 4-407 have some common law standing,[61] subsection (c) is an entirely new concept and allows the payor bank to go against the payee or any other holder of the check if the drawer has rights arising out of the transaction giving use to the check.[62] Under such a situation where the bank has paid over a stop payment order, the drawer will sue the bank instead of the payee because

58. For the full text of UNIFORM COMMERCIAL CODE § 4-407(b) see note 55 *supra*.
59. See UNIFORM COMMERCIAL CODE § 4-407, comment 2.
60. See UNIFORM COMMERCIAL CODE § 4-403(3).
61. See cases cited at note 56 *supra*.
62. Prior to the Code it had been held that subrogation rights against the payee were not permitted. See Third Nat'l Bank v. Carber, 31 Tenn. App. 520, 218 S.W.2d 66 (1948) (the payee had sold the drawer a worthless boat and the drawer had stopped payment but the bank had paid over the order and was trying to recover against the payee and the court did not allow the bank to go against the payee). For the full text of UNIFORM COMMERCIAL CODE § 4-407(c) see note 55 *supra*.

of the convenience and certainty of getting paid if he wins the law suit. An example is given under the comments of section 4-407 where the payee was a fraudulent salesman and induced the drawer to issue his check for the purchase of worthless goods and the bank paid the check over the drawer's stop payment order.[63] In such a situation, subsection (c) will not be of much value to the bank because it probably will not be able to find the fraudulent salesman. But where the payee is a respectable business or where the payee can be reached by the bank, subsection (c) does provide the bank with an effective remedy.[64]

Perhaps the most important supplement that a bank could use in the enforcement of section 4-407(c) subrogation rights would be to allow the drawee to "vouch in" the party against whom the rights are given. Assuming, for example, that the bank is faced with a situation where it missed a stop payment order, issued by the drawer because of defective goods, and it as a convenient defendant is sued by the drawer who does, in fact, establish the defective goods damages, the real question of the litigation is one concerning the drawer and the payee. It seems that to place the burden of two suits and the possibility of inconsistent results on the drawee is a little severe for missing a stop payment order.

Section 3-803 of the Code,[64] it might be argued, allows a drawee to "vouch in" the party liable for the defective goods in conjunction with subrogation rights granted under section 4-407(c). The use of the sections in conjunction, however, is questionable. First, when a bank is sued for payment over a stop payment order, it would seem that technically the suit is for the breach of the obligation of not stopping payment and, therefore, it would not be the type of "obligation for which a third party would be answerable over . . ."[65] under section 3-803. The essence of stop payment litigation when defective goods are involved, however, centers on the establishment of drawer damages. Given the fact, therefore, that the drawee is a convenient defendant and is subrogated to the drawer rights "with respect to the transaction out of which the [check] arose" it seems that the drawee is in actuality being sued for

63. UNIFORM COMMERCIAL CODE § 4-407, comment 3.

64. UNIFORM COMMERCIAL CODE § 3-803 provides that:
Where a *defendant is sued for a breach of an obligation for which a third party is answerable over under . . . Article* [*Three*] he may give the third person written notice of the litigation. . . . If the notice states that the person notified may come in and defend and that if the person notified does not do so he will in any action against him by the person giving notice be bound by any determination of fact common to the two litigations, then unless after reasonable receipt of notice the person notified does come in and defend he is so bound. (Emphasis added.)

65. *Ibid.*

a "breach of an obligation for which a third party is answerable over. . . ."[66]

The most problematical element in the use of the sections together, however, arises when it is recognized that section 4-407(c) subrogates the drawee only to those rights of the drawer "with respect to the transaction out of which the [check] arose."[67] Whether such rights are of the type for which a third party is "answerable over under . . . Article [Three],"[68] as required by section 3-803, is definitely questionable. If a suit on defective goods were instituted by the drawer against the payee on the underlying obligation, certainly it would not be a suit under article 3.

A result that would deny the bank the "vouching in" remedy in a defective goods case, however, would appear to be completely fortuitous, depending on whether the stop payment order was missed or not, since if the bank had enforced the stop payment and dishonored the check, the payee would have the option to sue the drawer on either the instrument or the underlying obligation under article 3.[69] The ultimate question, whether it is (1) the drawer initiating suit against the drawee, who in turn is subrogated to the drawer's rights on the underlying obligation, or (2) the payee suing the drawer because the check was dishonored in a defective goods situation, centers on the underlying obligation. The real parties in interest are the drawer and the payee. It probably would strain logic, however, to fulfill the "answerable over under . . . Article [Three]" requirement by allowing a drawee to use section 3-802(1)(b) to "vouch in" the payee on the grounds that "if the instrument is dishonored action may be maintained on . . . the obligation."[70] Therefore, with due consideration to the merits of the drawee's position, it would seem that the addition of an article 4 "vouching in" right to the section 4-407(c) subrogation right would bring about an improved solution to stop payment litigation and eliminate the potential punitive effects of missing a stop payment order.

VI.

Indiana's adoption of the Uniform Commercial Code will enable the practicing lawyer to benefit from the scholarly study and timely draftsmanship which went into the formation of the Code. It will en-

66. *Ibid.*
67. UNIFORM COMMERCIAL CODE § 4-407(c).
68. UNIFORM COMMERCIAL CODE § 3-803.
69. UNIFORM COMMERCIAL CODE § 3-802(1)(b) provides that: "If the instrument is dishonored action may be maintained on either the instrument or the obligation."
70. UNIFORM COMMERCIAL CODE § 3-802(1)(b).

able him to have at his hand in one comprehensive piece of legislation the law that previously was in several uniform laws, as well as the common law. The Code, in stop payment difficulties as well as in other areas, will probably have a tendency to decrease the amount of litigation, since the rights and liabilities are spelled out more clearly than they have previously been. Parties, therefore, probably will be more willing to settle the claims out of court instead of litigating the problem.

In spite of the obvious improvement the Code has made by bringing together in one place the elements of stop payment law, a major problem is left unresolved as to whether a valid stop payment order release agreement can be drafted under section 4-103(1) of the Code between the bank and its depositors.[71] Since inadvertence, mistake or accident in the typical release has been construed as failure to exercise "ordinary care," the words will have to take on new meaning or banks will have to redraft their release agreements. In a redraft of release agreements, it would seem that banks will have to follow a negative approach to prevent any possible failure to exercise "ordinary care" connotations from attaching to a positive word of disaffirmance. A suggested statement in the negative might provide that the bank will not beliable for payment over a stop payment order if good faith and ordinary care are exercised. If the banks do take the negative approach, however, the question of what would be ordinary care is still unresolved. Consequently, the only answer would seem to be for the judiciary to find an area, if any such area exists, between strict bank liability and bank failure to exercise ordinary care.

BANK COLLECTION UNDER THE UNIFORM COMMERCIAL CODE

I. An Introduction to the Problem

When is a check finally paid? At what particular moment does the payee lose his rights against the drawer and receive his rights against a bank? Are these rights against his own bank, the drawer's bank or both of them? These and many similar questions are clearly not academic. The fact that a high percentage of checks are paid[1] does not detract from

71. See note 22 and accompanying text *supra.*

1. "The Federal Reserve Bank of Boston reported in 1947 that during the year 1946 dishonored items represented 40/100ths of 1% of all items handled by the Federal Reserve Bank of Boston and in dollar amount involved 27/100ths of 1%." Malcolm, *Article 4—A Battle With Complexity,* 1952 Wis. L. Rev. 265, 269 n. 31 (1952).